

STATEMENT OF SENATOR CARL LEVIN (D-MICH)
BEFORE THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
ON
EXCESSIVE SPECULATION IN NATURAL GAS PRICES
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In recent years, allegations of price manipulation and excessive speculation have erupted in every sector of our energy markets, from the ongoing litigation over Enron's distortion of electricity prices, to price manipulation charges in the propane market, to allegations of price gouging in gasoline. Just one year ago our Subcommittee released a report showing how rampant speculation was inflating crude oil prices by \$20 per \$70 barrel of oil. When manipulation or excessive speculation distorts our markets, it is the American public that pays the price.

Today's hearing examines one case history that illustrates the current chaotic and dangerous vulnerability of U.S. energy markets to price manipulation and excessive speculation. Our focus is on an \$8 billion hedge fund called Amaranth Advisors LLC which, before its collapse in September 2006, was the dominant speculator in the U.S. natural gas market.

Natural gas is a vital U.S. energy source. It heats the majority of American homes, is used to harvest crops, powers 20% of our electrical plants, and plays a critical role in many industries, including manufacturers of fertilizers, paints, and medicines. It is one of the cleanest fuels we have, and we produce most of it ourselves with only 15% being imported, primarily from Canada. In 2005 alone, U.S. consumers and businesses spent about \$200 billion on natural gas.

For much of 2006, until Amaranth collapsed, futures prices for winter gas were unusually high despite ample natural gas supplies. To understand why prices remained high despite ample supplies and why Amaranth went from billions to broke overnight, the Subcommittee subpoenaed and reviewed millions of trading records from the two leading U.S. commodity exchanges that trade energy, the New York Mercantile Exchange or NYMEX, and the Intercontinental Exchange or ICE, as well as from Amaranth and other traders, all of whom cooperated with our inquiry.

The trading records show that, in 2006 until its collapse, Amaranth dominated trading in the U.S. natural gas market. It bought and sold thousands of natural gas contracts on a daily basis, and tens of thousands on some days. It used those trades to accumulate massive natural gas holdings, called "positions." The lead federal agency that oversees energy trading, called the Commodity Futures Trading Commission or CFTC, defines "large traders" for reporting purposes as any trader with 200 natural gas contracts; NYMEX examines a trader's position if it exceeds 12,000 natural gas contracts in a month. Amaranth at times held 100,000 natural gas contracts in a month, an amount equal to 1 trillion cubic feet of gas. During 2006, Amaranth held about 40% of all the outstanding natural gas contracts on NYMEX, and as much as 75% of the natural gas contracts in a single month.

The report we are releasing today is filled with charts showing how Amaranth trades affected natural gas prices as far out as five years. Amaranth's trades had a common focus – that winter gas prices would be unusually expensive compared to summer and fall prices. In prior years, for example, futures contracts delivering natural gas in January cost \$1.00 to \$1.50 more than futures contracts delivering natural gas in October, due to higher demand in January, the peak of the home heating season. As this chart (Exhibit 2) shows, however, in 2006, January futures contract prices skyrocketed, exceeding October prices by \$4, more than twice the historic norm. This price difference is the largest between these two contracts in five years.

Amaranth's large-scale trading, which went on day after day throughout the spring and summer of 2006, was the key driver in this \$4 difference. At times during the summer, for example, Amaranth held 75% of the outstanding futures contracts to deliver natural gas in November; 60% of those delivering natural gas in January; and 60% of the those delivering natural gas in March. It was often the largest trader in winter gas futures. Other traders told the Subcommittee that, during the summer of 2006, the relative winter futures prices were "clearly out of whack," at "ridiculous levels," and unrelated to supply and demand. They also told the Subcommittee that they were reluctant to bet on falling winter prices, given Amaranth's demonstrated ability to boost prices through large trades.

The result was that anyone who used the futures market during the summer of 2006 to buy natural gas for delivery in the following winter paid unusually high winter prices compared to fall and summer prices. Natural gas consumers, like utilities, told the Subcommittee that when they went on the market in the summer to buy their winter gas and hedge against future price increases, they knew the winter prices were very expensive, and higher than made sense given ample supplies. But they had to buy. As one municipal utility told us, they couldn't afford to "roll the dice" and wait to see if natural gas prices fell later on; their budget required them to make a decision during the summer. They paid the inflated prices. So did their customers.

Market prices are supposed to be the result of the interaction of many buyers and sellers, not the result of massive trades by a dominant speculator with market power to affect prices. But in 2006, Amaranth dominated the market, and winter prices remained at extreme levels despite ample supplies.

It's one thing for a speculator like Amaranth to gamble on natural gas futures, in this instance betting on unusually high winter prices. It's another for Amaranth to make that bet with such large-scale trades that it pushed up prices and, in effect, put heavy pressure on consumers in the market to take the same gamble and pay sky-high prices for future winter purchases. Later, as Amaranth collapsed in September, winter prices fell dramatically, but by then many natural gas consumers were already locked in and couldn't take advantage of the lower prices.

Where were the regulators in all this? Hamstrung by the law. The key law, the Commodities Exchange Act, is riddled with exemptions, exclusions, and limitations that make policing energy markets almost impossible. The biggest problem is the so-called "Enron

loophole” which, at the request of Enron and others, was inserted into a bill at the last minute during a Senate-House conference in 2000. The Enron loophole exempts from government oversight energy and metals commodities traded on an electronic exchange by large traders.

This exemption has never made any sense. Why should U.S. regulators protect virtually every type of commodity against trading abuses – corn, pork bellies, you name it – but not energy when energy is so vital to our economy? Why should regulators have authority to police regulated markets like NYMEX, but not unregulated markets like ICE, when both affect energy prices? Some argue that the exemption makes sense, because large traders can take care of themselves on electronic exchanges and don’t need government protection. But government protection is not just for traders; it is also aimed at protecting the public from price shocks due to market manipulation and excessive speculation.

An example from the Amaranth case history shows how the Enron loophole makes it nearly impossible for regulators to prevent large-scale trading from triggering price spikes. By August 2006, Amaranth had huge natural gas holdings in the September and October 2006 futures contracts. NYMEX officials were alarmed that Amaranth might try to make last-minute, large-scale trades that would affect these contract prices, so they ordered Amaranth to reduce its holdings in both the September and October contracts.

In response, Amaranth reduced its NYMEX holdings, but at the same increased its holdings in those same contracts on ICE. Natural gas contracts are called futures on NYMEX and swaps on ICE, but there is no functional difference between them. This chart (Exhibit 6) shows Amaranth’s September natural gas holdings before and after NYMEX ordered it to reduce its size. The data shows that, in response to NYMEX’s order to reduce, Amaranth simply switched its holdings to ICE, where neither NYMEX or the CFTC could limit its trading.

Over the next two weeks, Amaranth even increased its holdings, outside of the scrutiny or regulatory reach of NYMEX and the CFTC. By the end of August, Amaranth held almost 100,000 September contracts and 90,000 October contracts, mostly on ICE. Those holdings are so large that, for 100,000 contracts, a change of one penny in the price of the contract translates into a profit or loss of \$10 million. NYMEX’s order in the end did nothing to reduce Amaranth’s holdings; it just caused Amaranth’s trading to move from a regulated to an unregulated market.

NYMEX also ordered Amaranth to refrain from large-scale trading during the final half hour of trading on the September contract, again to prevent any chance of price manipulation or excessive speculation. The last day for trading on that contract was August 29. The last half hour was from 2:00 to 2:30 p.m. The last half hour is important, because NYMEX calculates the final price for its futures contracts using a formula that focuses on the prices paid in the last 30 minutes of trading. The final contract price is important, because many natural gas contracts, both on and off the exchanges, incorporate the “final settlement price” of the relevant NYMEX futures contract.

Amaranth stopped trading the September contract on both NYMEX and ICE around 1:15 p.m. on August 29th. Amaranth explained that it stopped trading on ICE as well as NYMEX, because its traders coordinate their trading on both markets, and it didn't want to trade on one without the other. In the days before August 29, Amaranth had engaged in a torrent of trading, selling tens of thousands of the September contract. On August 29th, Amaranth continued making large sales all day, but its sales were counterbalanced by other traders buying those contracts, the largest of which was a hedge fund called Centaurus. In the last half hour of trading, Amaranth stopped selling, but Centaurus and other traders continued buying, and the September contract price shot up 10%.

Altogether, on August 29, Amaranth sold about 16,000 September contracts, while Centaurus bought about 12,000, almost all on ICE using swaps. NYMEX rules bar traders from holding more than 1,000 contracts in the last 3 days of trading on a contract. The ICE trading not only made a mockery of that limit, it clearly affected the NYMEX final price. For Amaranth, the last-minute price spike dropped the value of its holdings by nearly \$500 million.

Amaranth appears to have gotten a dose of its own medicine on August 29, and it didn't like it. On August 30, Amaranth wrote to the CFTC that the sudden September price increase didn't reflect supply and demand, but large-scale trading by market participants who "are not trading in a responsible manner." It demanded an inquiry. Amaranth's lead trader predicted in an email to another trader: "boy I bet you see some CFTC inquiries" into the September trading. The other trader reminded him, however, that most of the trades were on ICE using swaps which are outside CFTC authority. He wrote: "Until they monitor swaps no big deal." (Exhibit 7.)

"No big deal" – that's what one trader thought of CFTC oversight in the face of a torrent of trading and a huge last-minute price spike. Why? Because current law strips the CFTC of any authority to regulate ICE, even though ICE is a major U.S. energy exchange. Right now, the law requires U.S. energy market regulators to work blind to ICE trades and powerless to limit ICE trading, even when that trading threatens U.S. consumers with price manipulation and excessive speculation.

Understanding swaps, hedges, price spreads, and margin requirements is no easy task. Proving price increases were caused by excessive speculation is also difficult, especially since regulators have not provided clear criteria defining excessive speculation. But what is crystal clear and easy to understand is that Amaranth dominated the U.S. natural gas market in 2006. It used massive trades to bet the store that winter prices would be twice as high as summer and fall prices compared to past years. When Amaranth made that bet, it forced a lot of natural gas consumers to make the same bet and pay sky-high prices for winter gas, because they couldn't take a chance and wait to see if prices fell. When Amaranth collapsed in September, it was too late for many U.S. consumers to take advantage of the lower prices that followed.

Congress needs to do much more to safeguard U.S. energy markets from price manipulation and excessive speculation. The first step is to close the Enron loophole. Closing this loophole would make NYMEX and ICE subject to the same market oversight, and put the

cop on the beat in all U.S. energy markets. It would also level the regulatory playing field between the two exchanges.

Last week, the CFTC issued a proposed rule that would curb but not end the ill effects of the Enron loophole. The proposed rule would require all traders on regulated exchanges like NYMEX to disclose, upon request from a regulator, all holdings on unregulated exchanges like ICE. The CFTC notes the “close relationship” between regulated and unregulated commodity markets and the need to get a complete picture of a trader’s holdings in order to prevent price manipulation and excessive speculation. The proposed rule is, in essence, a belated acknowledgment of the Amaranth facts. If finalized, this proposal would increase regulators’ access to key market information. But getting key information is not enough if regulators remain powerless to act on what they see. Regulators must also be able to reduce holdings and limit trades to prevent price manipulation and excessive speculation. Only Congress can eliminate the Enron loophole once and for all, and restore regulatory authority over all U.S. energy markets.

A second step in safeguarding U.S. energy markets is to invigorate the statutory prohibition against excessive speculation. It needs to be more effectively enforced with better criteria. The CFTC and exchanges also need to police contracts in all months where speculative trading is affecting prices – not just the contracts about to expire – and stop the excesses.

The third step is for Congress to provide the funds that the CFTC needs to do its job. Right now, the CFTC’s entire budget is \$98 million per year to oversee commodity trades in the billions. It is one-eighth the size of the SEC’s budget of \$880 million. The CFTC suffers from antiquated technology, shrinking staff, and inadequate oversight resources. To obtain the needed funds, Congress should authorize the CFTC to collect user fees from the markets it oversees, in the same manner as every other federal financial regulator, including the SEC. The CFTC has been starved for resources too long.

In 2006, excessive speculation by a single hedge fund, Amaranth Advisors, altered natural gas prices, caused wild price swings, and socked consumers with high prices. It’s one thing when speculators gamble with their own money; it’s another when they turn U.S. energy markets into a lottery where everybody is forced to gamble with them, betting on prices driven by aggressive trading practices. Amaranth is not the only hedge fund to use large-scale trading in U.S. energy markets. To stop the abuses, we need to put the cop back on the beat in all U.S. energy markets with stronger tools to stop price manipulation and excessive speculation.

I look forward to the testimony of the witnesses.